

A SCRIVENER'S "DELIGHT"—THE MARITAL DEDUCTION FORMULA CLAUSE

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The type of will that best suits a testator's needs depends on the nature of the property involved and the prospective beneficiaries of the estate, and requires the exercise of the estate planner's professional judgment. In drafting a will to meet these needs, the estate planner frequently finds it necessary to provide a surviving spouse with an outright gift of property equal in value to the maximum marital deduction. A thorough knowledge of the types of marital deduction formula clauses that produce this maximum deduction is essential to the task of sound testamentary planning. This article is concerned with those clauses, which some consider to be the most complex of estate planning tools. While the analysis that follows has a certain general applicability, one of its principal objectives is the study of the ramifications and complexities which accompany the use and administration of maximum marital deduction formula clauses under Ohio law.

Before examining the formula clauses in detail, it will be helpful to consider some of the options available to the executor to vary the maximum marital deduction. Within limits, the size of the marital deduction can be varied by the exercise of certain options given the executor by the Internal Revenue Code. The major focus of this article is a consideration of the formula pecuniary bequest and the formula fractional bequest. The dichotomy between these fundamentally different estate planning techniques, each of which defines the proportionate part of the estate needed to obtain the maximum marital deduction, provides a convenient framework within which the study of the formulas can be conducted.

I. INTRODUCTION

A decedent's individual taxable year ends on the date of death, and a new taxable entity, the estate, then comes into being. In calculating a decedent's federal estate tax,¹ the Internal Revenue Code of

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¹ A federal estate tax return must be filed by the executor within nine months of the date of death of the decedent when the value of the assets in the gross estate is \$60,000 or more. INT. REV. CODE OF 1954 §§ 2002, 2052, 6075 [hereinafter cited as CODE].

1954 provides for a deduction from the gross estate of an amount equal to the value of any interest which passes or has passed from the decedent to the surviving spouse, the so called marital deduction.² The maximum amount which can be claimed as a marital deduction is one-half of the adjusted gross estate, and the deduction is allowed only to the extent that such interests are included in determining the value of the decedent's gross estate.³ In order to obtain the marital deduction the executor must establish that the property that passes from the decedent to the surviving spouse qualifies for the marital deduction and that the technical requirements of the statute are met.⁴ Most frequently, a formula marital deduction clause is used to secure the deduction and meet these requirements.

Once it has been decided to use a formula maximum marital deduction clause,⁵ the estate planner is faced with the question of

² The most important substantive distinction between federal estate tax law and Ohio estate tax law is that there is no marital deduction for Ohio estate tax purposes. Ohio does however, allow an exemption equal to the value of any interest in property included in the value of the decedent's gross estate and that is, or has been transferred to or for the benefit of and is vested in the surviving spouse. Effective November 28, 1975, the Ohio estate tax exemption was increased from \$20,000 to \$30,000. OHIO REV. CODE ANN. § 5731.15(A)(2) (Page 1975) [hereinafter cited as OHIO REV. CODE].

³ The adjusted gross estate is computed by subtracting from the entire value of the gross estate the total deductions allowed by CODE, §§ 2053, 2054; *see* § 2056(c)(2)(a). The term adjusted gross estate has relevance only in defining the maximum allowable marital deduction.

⁴ While a discussion of the technical requirements needed to obtain the marital deduction is beyond the scope of this article, property may be passed to the surviving spouse by any of four basic methods to qualify for the marital deduction: 1) outright devise or bequest, 2) a legal life estate coupled with the requisite power of appointment, 3) the creation of a trust whereby the surviving spouse has a life estate coupled with the requisite power of appointment, and 4) the creation of a trust whereby the surviving spouse has a life estate with the remainder payable to the surviving spouse's estate, the "estate trust."

⁵ All too often, the marital deduction formula clause is used automatically, without understanding its consequences or considering the surviving spouse's peace of mind in receiving only a portion of the consort's estate. Since use of the marital deduction formula clause is influenced by tax considerations, the estate planner should recognize that the utilization of a formula clause can, in certain circumstances, result in a greater tax liability than if only a portion of the marital deduction were claimed. In those cases where one spouse has the entire estate the best tax result can be achieved by using only so much of the marital deduction as is required to equalize the estates. When the amount required to equalize the estates is less than one-half of the adjusted gross estate the taxes paid by the combined estates will be greater if the maximum marital deduction is obtained through a formula clause. While the combined tax may be greater, this result does not mean that a formula clause should not be used. Even though the tax may be greater, a present tax savings will accrue to the estate of the first to die and this savings may be used to generate income during the surviving spouse's lifetime. If the surviving spouse's life expectancy is fairly long, the factor of tax deferment may be more important than the total tax bill. Additionally, if the surviving spouse dies within a ten year period, the survivor's estate will be entitled under § 2013 to a credit for previously taxed property. One must also realize that if the surviving spouse spends or gives away the marital

which formula to use. Regardless of the formula selected, it is essential to recognize that the primary reason for the use of a formula maximum marital deduction clause is to insure that the decedent's estate taxes will be minimized while also not unnecessarily adding taxable property to the surviving spouse's estate. If, on the other hand, the objective is to insure that the death taxes paid by the estate of the first to die are as low as possible, without regard to the surviving spouse's subsequent estate taxes, a formula maximum marital deduction clause is unnecessary. This objective can be met by simply leaving the entire estate outright to the surviving spouse.

II. THE EXECUTOR'S POWER TO AFFECT THE ADJUSTED GROSS ESTATE

The executor can affect the size of the adjusted gross estate, and thus the amount of the marital deduction and estate taxes payable, not only by the exercise of the powers granted by the dispositive instrument, but also through the use of certain post-death tax management powers contained in the Internal Revenue Code. The power to select the alternate valuation date,⁶ the power to divide administrative expenses between the estate tax return and the estate income tax return,⁷ and the choices available in connection with medical expenses paid after the decedent's death⁸ are the principal ways the executor can affect the size of the adjusted gross estate. Since beneficiaries may raise questions about the exercise of these options when they are not clearly authorized in the will, a well drawn testamentary instrument ought to expressly authorize the executor to exercise these statutory options in the interest of overall tax reduction.

Property included in the gross estate is valued for federal estate tax purposes as of the date of death,⁹ subject to the right of the

deduction assets before death, the marginal estate tax increase may be avoided altogether. While the combined tax may be greater, the essential question that must be answered by the estate planner is whether the present savings associated with the greater marital deduction are worth the future costs which may be imposed on the surviving spouse's augmented estate at higher rates. It should be evident that the question cannot be answered mechanically.

⁶ CODE, § 2032.

⁷ CODE, §§ 2053(a), 642 (g). *See also* Treas. Reg. § 1.642(g)-2.

⁸ CODE, §§ 213(d), 2053(a).

⁹ The value is set by determining the price at which the property in question would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. All relevant facts and elements of value as of the valuation date must be considered in determining value. This fair market value approach is the same for federal estate tax purposes as it is for Ohio estate tax

executor to elect the alternate valuation date. Except as to assets which have been sold, distributed, or otherwise disposed of within the period,¹⁰ the alternate valuation date is six months after the decedent's death.¹¹ An election of alternate valuation at higher values will increase the marital deduction since it will increase the value of the adjusted gross estate. The executor will normally select the alternate valuation date if the value of the assets on that date is lower than the value of the assets at the date of death, thus reducing the estate's tax liability. Electing the alternate valuation date, however, may be advantageous even though the alternate valuation values are higher than the date of death values, since the values used for federal estate tax purposes determine the basis of the assets included in the gross estate,¹² and have a direct bearing on the income tax liabilities of the estate and its beneficiaries. Obviously, a lower basis results in a greater gain and a greater tax when the property is sold. While an income tax advantage may be obtained by valuing the assets at the higher of the two valuation dates, any decision to value on the high side is obviously made at the expense of some increase in the estate tax. From a tax standpoint, therefore, valuing on the high side is advantageous only when the income tax saving more than offsets the additional estate tax.

Most expenses incurred by the estate during the period of administration can be divided between the estate tax return and the estate's income tax return.¹³ Except for funeral and burial expenses, which are deductible only on the estate tax return, and administrative expenses allocable to exempt income that cannot be deducted on the

purposes. Treas. Reg. § 20.2031-1(b), T.D. 3863, 1965-2 CUM. BULL. 367; OHIO REV. CODE § 5731.10(B) (1973).

¹⁰ CODE, § 2032(a)(1) provides that such properties shall be valued as of the date of distribution, sale, exchange, or other disposition. Under Treas. Reg. § 20.2032-1(c)(2)(i), the date of the court's order of distribution fixes the valuation date.

¹¹ CODE, §§ 2031, 2032. Section 2032 was amended in 1970, 84 Stat. 1836, to shorten the alternate valuation date from one year to six months in the case of those persons dying after December 31, 1970. In estates of decedents dying after April 1, 1972, an alternate valuation date is available for Ohio estate tax purposes that conforms to the alternate valuation date for federal estate tax purposes. Otherwise, the gross estate is valued as of the date of the decedent's death. OHIO REV. CODE § 5731.01(A) (1973).

¹² Generally, § 1014 confers a new basis upon all property included in the decedent's gross estate. The major exceptions are found in the CODE, §§ 1014(b)(9)(A), 1014(c).

¹³ CODE, §§ 2053(a), 642(g). Deducting administrative expenses on the federal estate income tax return does not affect the Ohio estate tax. Under OHIO REV. CODE § 5731.16(A)(2) (1973) the gross estate for Ohio estate tax purposes is reduced by administration expenses "to the extent that such expenses have been or actually will be paid."

income tax return,¹⁴ the administrative expenses that can be divided between the two federal returns include attorney's fees, the executor's commission, appraisal fees, investment counsel commissions, and in general all those fees and costs incurred during the administration of the estate that would ordinarily be deductible by an owner or investor.¹⁵ The deduction is limited to those expenses that are actually and necessarily incurred in the administration of the decedent's estate.¹⁶ Those expenses which are not essential to the proper settlement of the estate may not be taken as deductions.¹⁷ To the extent that administrative expenses are deducted on the estate's income tax return, the size of the maximum marital deduction is increased, since the adjusted gross estate is larger than if the deduction were taken on the estate tax return. If, on the other hand, the administrative expenses are deducted on the estate tax return, the adjusted gross estate and thus the maximum marital deduction is diminished. The decisions as to the return on which the deductions will be taken¹⁸ and the extent to which they will be split between the two returns¹⁹ in most instances involve a rate comparison for the purpose of determining the best overall tax result.²⁰ The fact that the Internal Revenue Code permits excess deductions to be passed through and deducted in a residuary beneficiary's individual income tax return is also a factor in deciding how the executor should take the deduction.²¹ The

¹⁴ CODE, § 265(1).

¹⁵ Treas. Reg. § 20.2053-3, T.D. 6826, 1965-2 CUM. BULL. 367; CODE, § 2053(a) provides that "the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts . . . for administration expenses . . . as are allowable by the laws of the jurisdiction . . . under which the estate is being administered."

¹⁶ Treas. Reg. § 20.2053-3(a).

¹⁷ *Id.*

¹⁸ Treas. Reg. § 1.642(g)-2. The question of timing is also important. Only those expenses paid within the taxable year are deductible on the estate's income tax return.

¹⁹ While the deductions may be split between the two returns, a double tax benefit is precluded by CODE, § 642(g). See Treas. Reg. § 1.642(g)-2. If the deduction is taken for income tax purposes the executor must file a statement that the same deduction has not been taken for estate tax purposes. Expenses relating to the sale of estate assets may qualify for a double deduction. See Rev. Rul. 71-173, 1971-1 CUM. BULL. 204 and *In re Estate of Park v. C.I.R.*, 475 F.2d 673 (6th Cir. 1973).

²⁰ When the income beneficiaries and the residuary beneficiaries are different, the former benefit at the expense of the latter if the deduction is taken on the income tax side. The tax savings to the income beneficiaries occurs at the expense of increased estate taxes and requires an equitable adjustment. Depending on state law, equity may require that the loss suffered because of greater estate taxes be reimbursed by those benefiting, the so-called "Warms" adjustment. *In re Estate of Warms*, 140 N.Y.S.2d 169 (Sur. Ct. 1955); *accord*, *In re Estate of Bixby*, 140 Cal. App. 2d 326, 295 P.2d 68 (1956).

²¹ CODE, § 642(h).

pass-through deduction is frequently available because expenses paid by the executor in the final taxable year of the estate often exceed the estate's taxable income for the same period. The pass-through deduction is not available for expense deductions taken on the estate tax return.

Expenses for medical care that are paid by the decedent's estate during the one year period beginning the day after the date of death may be deducted as a debt of the estate.²² If deducted on the federal estate tax return, the full amount of the medical care is deductible without regard to the general percentage limitations normally associated with medical expense income tax deductions.²³ Taking the medical care deduction on the federal estate tax return reduces the adjusted gross estate. Alternatively, the executor can deduct these expenses on the decedent's final income tax return, which of course has the converse effect on the adjusted gross estate.²⁴ When the deduction is taken on the decedent's final income tax return the executor is required to waive the right to claim the same deduction on the federal estate tax return,²⁵ thus insuring that the deduction will not be claimed twice.

III. USING FORMULAS PROVIDING THE MAXIMUM MARITAL DEDUCTION

Although there are a variety of formula bequests designed to obtain the exact amount of the maximum marital deduction, they fall basically into one of two major types: formula pecuniary bequests and formula fractional bequests. Since both types are fixed by reference to the Internal Revenue Code's concept of the adjusted gross estate, both are self-adjusting to changes in the composition of the testator's estate prior to death. This self-adjusting feature is necessary because it is impossible in most cases to determine in advance of death the dollar amount which must pass to the surviving spouse in order to claim the maximum marital deduction.²⁶ Also common to

²² CODE, §§ 2053(a), 213(d)(1). For Ohio estate tax purposes there is no specific exemption for expenses incurred in connection with the decedent's last illness. Claims against the estate which are outstanding and unpaid as of the decedent's death are deductible on the Ohio estate tax return. OHIO REV. CODE § 5731.16 (1973).

²³ See CODE, § 213(a).

²⁴ CODE, § 213(d)(1) provides that "expenses for the medical care of the taxpayer which are paid out of his estate during the 1-year period beginning with the day after the date of his death shall be treated as paid by the taxpayer at the time incurred."

²⁵ CODE, § 642(g), Treas. Reg. § 1.642(g)-1.

²⁶ For a discussion of the potential danger associated with the self-adjusting feature, *see*,

both major types of formula bequests are mechanisms to protect against overfunding the marital share. Since the use of formula bequests does not preclude the concurrent use of specific bequests or other transfers to the surviving spouse, overfunding is avoided by reducing the formula amount of the marital bequest by the value of those items that pass to the surviving spouse by will, by survivorship, under life insurance policies or otherwise, and that qualify for the marital deduction. Failure to take these items into account can result in more property passing to the surviving spouse than is needed in order to obtain the maximum marital deduction. Any property passing to the surviving spouse in excess of the maximum marital deduction results in the potential disadvantage of double taxation.²⁷

Before any type of marital bequest is utilized by the estate planner, the testator's preferences and the composition of the estate assets must be carefully examined to determine which type of formula bequest is most advantageous. Basically, the estate planner may express the marital deduction either as a bequest of a dollar amount through the use of a pecuniary formula, or as a fractional share of the estate, usually the residuary, through the use of a formula fractional bequest. The distinction between these two approaches is both theoretically and conceptually clear, but a study of the judicial decisions construing various clauses demonstrates that it is not always easy to tell whether a pecuniary bequest or a fractional bequest has been used.²⁸ Since the formula pecuniary bequest appears to be far more popular with estate planners than the formula fractional bequest, it will be discussed first.

A. *Formula Pecuniary Bequests*

The dollar amount of the formula pecuniary bequest is frequently expressed as "an amount equal to the maximum marital deduction under federal estate tax law" or by direct reference to the

e.g., C. LOWNDES, R. KRAMER, & F. MCCORD, *FEDERAL ESTATE AND GIFT TAXES*, ch. 42 (3d ed. 1974). Formula clause critics maintain that it is poor drafting to tie the formula clause to the tax law, which is subject to change. If the tax law changes, a burden is placed on the estate planner to review all outstanding wills and modify them accordingly.

²⁷ *Supra* note 5.

²⁸ The courts held that a pecuniary bequest was expressed in *In re Estate of Kautner*, 50 N.J. Super. 582, 143 A.2d 243 (1958) and in *In re Estate of Althouse*, 404 Pa. 412, 172 A.2d 146 (1961). The courts found a fractional bequest with similar language in *In re Estate of Bing*, 23 Misc. 2d 326; 200 N.Y.S.2d 913 (1960) and *In re Estate of Nicolai*, 232 Ore. 105, 373 P.2d 967 (1962).

adjusted gross estate. A pecuniary bequest expressed in terms of "one-half of the adjusted gross estate as finally determined for federal estate tax purposes" is a bequest of an amount.²⁹ The following clause is an illustration of a preresiduary pecuniary bequest and is presented as a basis for discussion:

I give to my wife, if she survives me, such additional funds and properties as may be required to afford my estate the maximum marital deduction under federal estate tax law, taking into account in reduction of such amount all items which qualify for said deduction and which pass or have passed to my wife under other provisions of my will, by right of survivorship, under life insurance policies, or otherwise than under this paragraph. The computation of the amount distributable under this paragraph shall be based on the final determinations in the federal estate tax proceedings. This is intended as a preresiduary gift and shall be free of federal and state death taxes.

The relative ease with which this type of marital bequest is expressed, calculated, and administered has contributed significantly to its popularity. These advantages should be considered economically significant since they may be translated into lower costs. Further, as will be seen, these advantages are not as readily available under the more complex formula fractional bequest.³⁰

The pecuniary bequest entitles the surviving spouse to a fixed dollar amount on the date of distribution. The spouse's interest as determined by the formula does not vary as a result of economic factors occurring between date of death and date of distribution or, if the alternate valuation date is selected, between that date and the date of distribution.³¹ Since the surviving spouse is entitled to a certain sum of money, rather than any particular assets, the pecuniary bequest, as a general charge against the estate, avoids the problem of fractionalizing the property interests in particular assets.³²

Generally the pecuniary bequest also insures that the surviving spouse's claim will take precedence over gifts made out of the residuary portion of the estate. Whenever the testator's estate is insufficient to satisfy all the bequests or devises, the shares of some or all of the beneficiaries under the will obviously must be reduced or

²⁹ Tarbox, *The Pregnant Marital Deduction*, 112 TRUSTS AND ESTATES 414 (1973).

³⁰ See text accompanying notes 98-99 *infra*.

³¹ The valuation date is either the date of death or the alternate valuation date determined pursuant to CODE, § 2032.

³² See text accompanying notes 80-82 *infra*.

abated. When the will is silent on the order of abatement and the testator's preferences cannot be ascertained by construction, Ohio law dictates that shares abate according to the common law, that is, property not disposed of by will, residuary bequests, general bequests, and specific bequests.³³ Within each class abatement occurs on a pro rata basis.³⁴

If the testator's objective is to freeze the value of the surviving spouse's share and shift the burden of any estate changes which occur during administration to the residuary beneficiaries, the pecuniary bequest is an appropriate and effective device.³⁵ As a general rule, the pecuniary bequest ensures that any appreciation or depreciation in the value of the estate assets and any income earned during administration will be held for the account of the residuary beneficiaries.³⁶ The effects associated with freezing the surviving spouse's share to the fixed amount of the marital deduction should not be viewed as undesirable, unless, of course, the result is produced unwittingly.

If the estate is composed of assets, such as securities, that are sensitive to declining economic conditions, the estate planner should realize that the pecuniary bequest may have an adverse effect on the testator's overall estate plan. Since the pecuniary formula produces a fixed amount, a falling market may seriously deplete the residue or, even worse, leave the executor short in his ability to completely satisfy the marital share.³⁷ The executor's desire to discharge his responsibility to the surviving spouse before the changing market makes it impossible to do so may also compound the adverse effect on the overall estate plan by destroying or limiting any post-mortem income tax planning possibilities.³⁸ Accordingly, the economic interrelation of the formula pecuniary bequest and the testator's overall estate plan should always be considered by the estate planner before

³³ Varner v. French, 12 Ohio L. Abs. 609 (Ct. App. 1932). See also OHIO REV. CODE §§ 2107.53 and 2107.54.

³⁴ Mastics v. Kiraly, 196 N.E.2d 172 (P. Ct. 1964). See generally, ATKINSON, LAW OF WILLS, 754 (2d ed. 1953).

³⁵ See text accompanying notes 31-32 *supra*.

³⁶ Any unused capital losses or operating losses may also be carried over and deducted by the residuary beneficiaries in their individual income tax returns for the current year. CODE, § 642(h).

³⁷ Geller, *Inflation and Recession*, 114 TRUSTS AND ESTATES 384, 385 (1975).

³⁸ The significance of post-mortem planning is succinctly stated in the following observation: "Post-death planning is of tremendous importance; the tax savings alone can often exceed all probate expenses if the planning is first-rate. One of the most important aspects is post-death income tax planning involving adroit distributions that will split income and utilize the lowest available income tax brackets." Eubank, *The Future for Estate Lawyers*, 10 REAL PROP., PROBATE & TR. J. 223, 227 (1975).

the will is drafted, regardless of economic conditions at that time.

In some states a pecuniary beneficiary is entitled to interest during the period of administration or after the lapse of a particular period of time.³⁹ Where such rights exist, the need for the additional liquidity to discharge this obligation may be viewed as a disadvantage of the pecuniary formula.⁴⁰ Under Ohio law, however, the surviving spouse is not entitled to interest on the pecuniary bequest unless the will provides for the payment of interest.⁴¹ Since the surviving spouse obviously cannot realize any return on the bequest until it is distributed, the Ohio executor is likely to be in the uncomfortable position of being pressed for distribution. Five months following the appointment of the executor, the surviving spouse may apply to the probate court, pursuant to statute, for a distribution in cash or in kind.⁴²

Inclusion of a provision specifying that the pecuniary bequest "shall be free of federal and state death taxes" assures that no tax burden will be affixed to the pecuniary bequest.⁴³ This provision does not mean, however, that those items that qualify for the marital deduction and pass to the surviving spouse by other provisions of the will, by survivorship, under life insurance policies, or otherwise, will not generate estate tax liability for which the surviving spouse will be liable. The exoneration clause in the illustrated pecuniary bequest does not detail the exact manner in which the tax burden is to be shared by persons interested in the estate. Therefore some other provision in the will must be included to perform this function. The absence of such a tax apportionment clause can have a disastrous effect on an estate plan, and can result in the reduction of the marital deduction or even in its elimination.⁴⁴

³⁹ The Uniform Probate Code, which has been adopted in ten states, provides that a general pecuniary device shall bear interest at the legal rate beginning one year after the appointment of the personal representative unless the will provides to the contrary. UNIFORM PROBATE CODE § 3-904.

⁴⁰ Geller, *supra* note 37, at 386.

⁴¹ OHIO REV. CODE § 2113.531 (1968) provides that general legacies bear no interest unless specifically authorized in the will.

⁴² OHIO REV. CODE § 2113.54 (effective Nov. 28, 1975).

⁴³ See the sample preresiduary pecuniary bequest clause *supra*.

⁴⁴ In the absence of a contrary provision in the will, the Internal Revenue Code of 1954 fixes the federal estate tax burden for that portion of the tax attributable to insurance and appointive property under §§ 2206 and 2207. These sections provide that if the beneficiary of the life insurance or the recipient of property subject to a taxable power of appointment is the surviving spouse, there is no obligation to contribute to the estate tax to the extent that the property passed free of tax under the marital deduction.

All states grant the testator the option of directing how the tax burden is to be borne. States differ, however, on the allocation of taxes in the absence of such a provision. Some states apportion the tax among the beneficiaries either by statute or by the doctrine of equitable apportionment. Other states provide for payment of the tax out of the residuary by case law. The law is well settled, however, that the allocation of estate taxes is determined according to the law of the decedent's domicile.

When a testator domiciled in Ohio dies leaving only probate assets generating tax liability, and without specifically designating which beneficiaries must bear the estate tax burden, case law directs the taxes be considered a charge against the general assets of the probate estate.⁴⁵ This means that the surviving spouse and the other beneficiaries of general legacies and specific bequests are entitled to have the entire tax burden fall on the residuary beneficiaries. A recent Sixth Circuit case has also established that in Ohio the surviving spouse is not required to contribute to the payment of estate taxes with regard to nonprobate transfers that do not generate tax liability.⁴⁶ Thus, under Ohio law the surviving spouse may be required to contribute to the payment of taxes, but only to the extent the assets passing to the spouse engender taxes. Even though it is unlikely that a surviving spouse will be required to contribute to the payment of estate tax under Ohio law when a formula pecuniary bequest is made, the matter should not be left to chance. Prudent estate planning calls for the specific designation of those beneficiaries who are to bear the estate tax burden.

Receipt by the surviving spouse of the specific dollar amount determined by the pecuniary formula does not produce a taxable transaction for the estate. When an estate makes distributions in kind, however, pursuant to the authority conferred by the will, by local law,⁴⁷ or by agreement among the beneficiaries, the estate planner should be aware of the possible capital gains consequences accompanying such a distribution in satisfaction of a formula pecuniary

⁴⁵ See *Oviatt v. Oviatt*, 24 Ohio Misc. 98, 260 N.E.2d 136 (P. Ct. 1970). Ohio has not enacted an apportionment statute.

⁴⁶ *In re Estate of Penny*, 504 F.2d 37 (6th Cir. 1974). For a recent case discussing the policy of requiring the surviving spouse to bear directly or indirectly any portion of the federal estate tax when no part of the spouse's share contributes to the tax burden and the will includes no direction concerning payment, see *Robinson v. United States*, 518 F.2d 1105 (9th Cir. 1975). Nonprobate transfers that generate additional estate taxes are required to contribute under the principle of equitable apportionment. Thus case law indicates that Ohio has adopted the selective application of the doctrine of equitable apportionment. See *Y.M.C.A. v. Davis*, 106 Ohio St. 366, 140 N.E. 114 (1922), *aff'd* 264 U.S. 47 (1924); and *McDougall v. Central Nat'l Bank*, 157 Ohio St. 45, 104 N.E.2d 441 (1952).

⁴⁷ OHIO REV. CODE § 2113.53 (Supp. 1974).

bequest. When the executor makes a distribution in kind to the surviving spouse, the estate realizes a taxable gain if the market value of the property rises between the date on which it is valued for estate tax purposes and the date on which it is distributed.⁴⁸ The distribution of an asset which has appreciated in value is treated for tax purposes as though it were a sale of property by the estate, and the gain from the sale must be reported on the estate's income tax return. Likewise, when the value of the property has decreased in the interim, the estate realizes a loss under the pecuniary formula.⁴⁹ From the point of view of the surviving spouse, the distribution in kind is in the nature of a purchase and the basis of the property in the spouse's possession is stepped up to the purchase price. The fair market value of the asset on the date of the transfer, rather than the estate's basis under § 1014, becomes the surviving spouse's basis. Obviously, receiving property with a greater basis may be desirable when the surviving spouse intends to resell the property, but unless the property is depreciable,⁵⁰ the availability of the increased basis is not particularly significant otherwise.

Under Ohio law, unless an executor is specifically empowered by the will to do so, he may make distributions "in cash or in kind" only under the payment of legacies statute.⁵¹ Before making a distribution in kind of assets which are not specifically bequeathed, the executor must obtain the approval of the probate court or the consent of all the legatees or distributees whose interest may be affected by the distribution.⁵² The statute does not set out the procedure to be followed if the executor is going to act solely on the authorization of the probate court, but it is presumably the same as in obtaining other orders of distribution.⁵³ Notwithstanding this statutory authoriza-

⁴⁸ Treas. Reg. § 1.1014-4(a)(3) provides that if the executor satisfies a pecuniary marital deduction bequest with appreciated property the estate must recognize as taxable gain the difference between the value of the property on the date of distribution and the amount of the bequest. If the estate has unused capital losses, the distribution of appreciated property to the surviving spouse may result in a nontaxable gain to the estate to the extent of offsetting capital losses. The regulation further provides that the surviving spouse acquires, as a basis of the property received, the value thereof on the date of distribution.

⁴⁹ The loss may be disallowed, however, because of the relationship of the parties. CODE, § 267.

⁵⁰ When the estate contains property subject to depreciation, a higher estate tax value will result in a higher base on which to compute the depreciation deduction for income tax purposes.

⁵¹ OHIO REV. CODE § 2113.53 (Page Supp. 1975). Under § 2113.38 a surviving spouse is given the right to purchase real and personal property not specifically devised or bequeathed by the decedent.

⁵² OHIO REV. CODE § 2113.55 (1968). When consent is sought, it should, of course, be obtained in writing from the parties.

⁵³ Johnson, *Distribution and Accounts*, 48 OHIO BAR 291 (1970).

tion, express authority should be routinely provided in the will, since it is frequently advantageous for the estate to deliver property to a beneficiary rather than paying cash. The size of the surviving spouse's cash claim makes specific authorization particularly relevant when the testator uses a formula pecuniary bequest.

Prior to 1964, the executor could satisfy the pecuniary gift with assets that had depreciated in value, if he was authorized to value any distribution in kind in satisfaction of the marital pecuniary gift at the value as finally determined for federal estate tax purposes. Thus the size of the deduction would be greater than the value of the property passing to the surviving spouse, enabling the decedent's estate to claim a deduction based on federal estate tax values while also reducing the amount that was to be taxed in the survivor's estate. Since one of the justifications for the marital deduction is that the value of the property allowed as a deduction will eventually be taxed in the survivor's estate unless spent or given away during the survivor's lifetime, the executor could circumvent the policy of the marital deduction statute by making a distribution of depreciated assets. This practice was interdicted in March of 1964, when the Internal Revenue Service issued Revenue Procedure 64-19.^{53,1} Put simply, 64-19 states that the marital deduction will be disallowed where the executor is authorized to make a distribution in kind in satisfaction of the pecuniary bequest and to value the assets distributed at estate tax values.

Although 64-19 has had an important effect on the use of pecuniary bequests, the limits of its applicability should be recognized. It does not apply to pecuniary bequests, whether of a stated amount or an amount computed by formula, when the executor may distribute the marital bequest only in cash, or has no discretion to select assets to be distributed in kind, or when the assets used to satisfy the marital bequest are valued as of the date of distribution. The Revenue Procedure is also inapplicable when the executor does not have the right to distribute in kind, when the bequest is one of specific assets, when the will or applicable state law directs that the assets distributed have an aggregate fair market value at the date of distribution not less than the amount of the pecuniary gift, or when the will or applicable state law directs that the assets distributed be fairly representative of the appreciation or depreciation in value of all property available for

^{53,1} Rev. Proc. 64-19, 1964-1 CUM. BULL. (Part I) 682.

distribution. It is also inapplicable when the formula fractional bequest is used.⁵⁴

Ohio, like many other states,⁵⁵ has attempted to ensure routine compliance with 64-19 by legislation.⁵⁶ The Ohio statute applies when the executor is authorized to select assets to satisfy the marital deduction gift and to allocate assets in satisfaction of the gift at values other than market values at the time of distribution. While the statute is clearly applicable to formula pecuniary bequests,⁵⁷ it is also sufficiently broad to cover any dollar amount gift to the surviving spouse whether expressed in terms of a formula clause or not.

When not otherwise directed by the testator, the executor is required by the Ohio statute to distribute assets which are "fairly representative" of the overall appreciation or depreciation of the property available when making a distribution in kind to the surviving spouse to satisfy a marital pecuniary bequest. By requiring that distributions take into account the appreciation and depreciation occurring in all estate assets available for distribution, the Ohio statute meets the requirements of 64-19, but it also changes the nature of the pecuniary formula and circumscribes the executor's options as to distributions and the use of post-mortem tax planning. The surviving spouse, although entitled to a fixed dollar amount, is now required to share in the fluctuation in the value of the assets during the period of administration. The economic changes in the value of the estate are no longer exclusively borne by the nonmarital share, as they are

⁵⁴ See Section C *infra*.

⁵⁵ ALA. CODE tit. 61, § 4(1) (Cum. Supp. 1973); ARK. STAT. ANN. § 62-2909.2 (1971); CAL. PROBATE CODE § 1029 (West Supp. 1975); COLO. REV. STAT. ANN. § 153-10-49 (1965); DEL. CODE ANN. tit. 12, § 2321 (Supp. 1974); FLA. STAT. ANN. § 734.031 (Cum. Supp. 1975); GA. CODE ANN. § 113-1037 (1975); MD. EST. & TRUSTS CODE ANN. § 11-107 (1974); MINN. STAT. ANN. § 525.528 (1969); MISS. CODE ANN. § 91-7-39 (1972); N.Y. EST. POWERS & TRUSTS § 2-1.9 (McKinney Supp. 1974); N.C. STAT. ANN. § 28A-22-5 (1975); OHIO REV. CODE ANN. § 1339.41 (Page Supp. 1974); S.C. CODE §§ 19-567 to 19-569 (Cum. Supp. 1974); TENN. CODE ANN. § 30-1317 (Cum. Supp. 1974); VA. CODE ANN. § 64.1-74 (1973); W. VA. CODE ANN. § 44-5-12 (Cum. Supp. 1975); WIS. STAT. ANN. § 863.19 (1971).

⁵⁶ Ohio's "fairly representative" statute provides:

Whenever the executor of a will or the trustee of a testamentary or inter vivos trust is permitted or required to select assets in kind to satisfy a gift, devise, or bequest, whether outright or in trust, intended to qualify for the federal estate tax marital deduction . . . the executor or trustee shall satisfy such gift, devise, or bequest by distribution of assets having a value fairly representative in the aggregate of appreciation or depreciation in the value of all property, including cash, available for distribution in satisfaction of such gift, devise, or bequest, unless the will or trust instrument expressly requires that distribution be made in a manner so as not to be fairly representative of such appreciation or depreciation.

OHIO REV. CODE § 1339.41. (Supp. 1974).

⁵⁷ OHIO REV. CODE § 1339.41 (Supp. 1974).

under what might be now labeled the true pecuniary bequests.⁵⁸ The Ohio statute has thus converted the pecuniary legacy into a type of hybrid formula fractional bequest. It is hybrid in the sense that the surviving spouse shares in the overall appreciation or depreciation of the assets almost as though the marital share had been given in terms of a fractional share of the residuary.⁵⁹

Since the executor is required to distribute assets which are "fairly representative" of the overall appreciation or depreciation, a distribution of appreciated property can be made without the estate incurring a capital gains tax.⁶⁰ The capital gains problem is avoided because the estate is not satisfying a right to a fixed and definite dollar amount, since the value of the right varies with changes in the value of the estate. Under Ohio law, since no capital gains are realized by the estate, the surviving spouse's basis in the property distributed in satisfaction of the pecuniary bequest is equal to the estate tax credit claimed by the estate.

Since the statute is expressed in terms of "unless the will or trust instrument expressly requires that distribution be made in a manner so as not to be fairly representative of such appreciation or depreciation,"⁶¹ the testator's choice in the matter is not fettered. However, unless the testator wants the surviving spouse to receive a proportionate share of appreciation or depreciation, he must exercise the option granted by the statute by inserting a specific provision in the will.

B. *Minimum Value Provisions*

An important variation of the formula pecuniary bequest defines the surviving spouse's share in terms of a minimum value, assuring the surviving spouse of an amount at least equal to the allowed marital deduction. Under the minimum share clause, the executor is required to satisfy the pecuniary bequest with assets whose fair market value at the distribution date is at least equal to the dollar amount allowed for federal estate tax purposes.⁶² By establishing a floor

⁵⁸ Tarbox, *supra* note 29.

⁵⁹ One of the more important questions unanswered by the statute is whether the surviving spouse is entitled to share in income earned by the estate during administration. Neither the wording of the statute nor the policy underlying its enactment necessitates that the surviving spouse share in the income.

⁶⁰ Discussion cited note 48 *supra* and accompanying text.

⁶¹ OHIO REV. CODE § 1339.41 (Supp. 1974).

⁶² The capital gains problem associated with funding the pecuniary bequest with appreciated assets may be avoided by providing that each asset distributed to the surviving spouse be valued at the lower of its value as of the date of distribution or its income tax basis. The

below which the marital share cannot fall, the minimum value clause gives the surviving spouse maximum protection. The following clause is illustrative of this type of bequest:

Any property distributed in satisfaction of said legacy shall be valued at its fair market value at the date of distribution or its income tax basis, whichever is lower, provided that the total value of all assets so distributed be not less than the amount of such legacy.

In addition, the clause guarantees that the requirements of 64-19 will be met.⁶³ Although the fair market value of any distribution will always be at least equal to the pecuniary amount fixed at the valuation date, the minimum value clause set out above does not prevent the surviving spouse from receiving assets which have appreciated in value.⁶⁴ This means that the surviving spouse may receive assets with a greater fair market value than the pecuniary amount which is fixed at the valuation date. For example, if the marital deduction is fixed at the valuation date at \$200,000, the executor is required by the minimum value clause to satisfy the surviving spouse's share with property worth at least \$200,000. The executor is not, however, prevented from distributing assets valued for estate tax purposes at \$200,000 that have a greater fair market value at the date of distribution.⁶⁵

If the estate planner's objective is to freeze the value of the assets received by the surviving spouse, the minimum value clause

estate will not be deemed to have sold or exchanged property unless (1) it has used estate assets to satisfy a fixed obligation to distribute a specified dollar amount and (2) the dollar amount is satisfied with assets having a basis to the estate which is not equal to that amount. Since the fair market value of the assets distributed may exceed the minimum, the ultimate value of the bequest is not ascertainable until distribution and the receipt of the assets cannot be said to be in satisfaction of a fixed dollar amount bequest or claim. Polasky, *Marital Deduction Formula Clauses in Estate Planning*, 63 MICH. L. REV. 809, 867-68 (1965). See generally, A. CASNER, ESTATE PLANNING 1284-85 (Supp. 1972).

⁶³ Rev. Proc. 64-19, 1964-1 CUM. BULL. (Part I) 682, § 2.02 provides, in substance, that where by virtue of the duties imposed on the fiduciary it is clear that he must distribute assets having an aggregate fair market value at the date of distribution amounting to no less than the amount of the pecuniary bequest as finally determined for federal estate tax purposes, the marital deduction may be allowed in full.

⁶⁴ The minimum value clause can be drafted to provide that the surviving spouse shall receive no less than the pecuniary amount, and, to the extent practical, no more than the amount of the legacy. Bush, *Marital Deduction Pitfalls and Their Legislative Cure*, 33 BROOKLYN L. REV. 508 (1967).

⁶⁵ Funding a minimum worth pecuniary bequest will never result in the recognition of gain to the estate, and, in fact, may result in the recognition of losses to the estate if the executor is alert on the distribution of assets. Rosen, *An Overview of Marital Deduction Formula Clauses*, 29 U. MIAMI L. REV. 47, 55 (1974).

may not be an appropriate device. It does, however, provide the executor with a certain degree of flexibility to vary the value of the property received by the surviving spouse. Although this flexibility may be desirable from a post-mortem planning standpoint, the clause should not be used when the residuary beneficiary is a charity, since the maximum amount of the surviving spouse's share is not determinable until the final distribution is made. One factor considered in determining the deductibility of the charitable gift is whether the charity is assured of receiving the bequest or some determinable part. As a result, the claim may be made that authority to distribute at either distribution date values or at the income tax cost basis makes the amount of the charitable gift unascertainable and possibly non-deductible.⁶⁶ The minimum value bequest should also be used with caution when the surviving spouse is the executor. In such a case funding the minimum value bequest with appreciated assets raises a conflict of interest issue.

As previously noted, Ohio's "fairly representative" statute⁶⁷ applies when the executor is empowered to satisfy the marital deduction bequest by allocating assets at any value other than market value. This possibility exists when the pecuniary bequest is expressed in terms of a minimum value. While no Ohio case has addressed the issue of whether the "fairly representative" statute applies when the executor is charged with satisfying a minimum value bequest, it may well be that the executor is required to distribute assets that are fairly representative of "the overall appreciation of all assets available for

⁶⁶ Treas. Reg. § 20.2055-2(b) T.D. 7318, 1974-2 CUM. BULL. 305, provides in part: If, as of the date of a decedent's death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an estate or interest has passed to, or is vested in, charity at the time of a decedent's death and the estate or interest would be defeated by the subsequent performance of some act or the happening of some event, the possibility of occurrence of which appeared at the time of the decedent's death to be so remote as to be negligible, the deduction is allowable. If the legatee, devisee, donee, or trustee is empowered to divert the property or fund, in whole or in part, to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed, devised, or given by the decedent, the deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of the power.

See also, *Stewart v. Comm'r*, 436 F.2d 1281 (3d Cir.), *cert. denied*, 404 U.S. 828 (1971); *First Nat'l Bank v. United States*, 443 F.2d 480 (5th Cir.), *cert. denied*, 404 U.S. 983 (1971).

⁶⁷ OHIO REV. CODE § 1339.41 (Page Supp. 1974).

distribution.”⁶⁸ If the statute does apply, the surviving spouse will in any event receive as a minimum the dollar amount of the bequest or, in the alternative, a ratable share of the appreciation or depreciation. The wording of the minimum value clause insures that the surviving spouse's share will not be charged with a net depreciation of estate assets.

At least two arguments can be made against the application of the “fairly representative” statute to the minimum value bequest. Since the statute applies only when the will contains no express provision to the contrary, the testator's direction that the surviving spouse receive a minimum value is at least arguably a sufficient expression of intent to make the statute inapplicable by its own terms. The minimum value bequest expresses the testator's wish that the surviving spouse not be forced to share in the net depreciation of the value of the estate. When this argument is buttressed by reference to the policy objective of the statute, this result becomes even more appealing. The policy of the “fairly representative” statute is to insure compliance with 64-19, so that the marital deduction will not be lost. Since the minimum value bequest complies with the requirements of 64-19,⁶⁹ one can argue that the statute should not apply to those cases that offer no conflict with the Revenue Procedure.

A finding that the statute does not apply would vest the executor with greater flexibility, allowing him to shift asset values to the marital share by funding the pecuniary bequest with assets which have appreciated in value, with the result that the nonmarital distributees may be prejudiced. Although the possibility of prejudice would be lessened by the application of the “fairly representative” statute, since the executor's power to prefer or to discriminate in favor of the surviving spouse would concurrently be eliminated, this hardly seems to be a problem that justifies its application.

C. *Fractional Share of the Residue*

When a fractional share marital deduction gift appears in a will, the residuary estate is the fund against which the fraction is normally applied. The formula language is generally expressed either as a fractional or as a percentage share of the residue.⁷⁰ The choice between

⁶⁸ 1 J. PLATT, ESTATE PLANNING IN OHIO § 4.4-5 (1969).

⁶⁹ Rev. Rul. 64-19, 1964-1 CUM. BULL. 682.

⁷⁰ Polasky, *supra* note 62, at 837, levels criticism at the use of the percentage method of expression.

these forms of expression is essentially an exercise in semantics, although the expression of the gift as a percentage share has been criticized as raising certain constructional problems.⁷¹ Regardless of the method used, the marital share is adjusted downward for other property passing to or for the benefit of the surviving spouse outside of or under any other provision of the will which qualifies for the marital deduction.⁷² Once the method of expressing the fraction has been chosen, the estate planner must specify the pool of assets on which the fraction is to operate. Basically, the will may either direct the executor to apply the fraction against the residuary estate remaining after the payment of debts and administration expenses but before taxes,⁷³ or against what is left after the payment of estate taxes as well as debts and administration expenses.

The fraction in the formula may be stated in general terms or in detail. The following clauses are presented as typical illustrations of these alternative methods of expression:

Formula For Fractional Share of Residue

The residue of my estate I devise and bequeath as follows:

To my wife, if she survives me, such fractional share of my estate, which added to all other property included in the amount determined and allowed as a marital deduction in the federal estate tax proceedings in my estate, shall be equal to one half of my adjusted gross estate as defined in any law imposing a succession, inheritance, estate or death tax. The values to be used for computing such fractional share shall be the values finally determined in the federal estate tax proceedings and shall be conclusive.

Fractional Formula Based on Numerator and Denominator

In the event that my wife survives me, I give, devise, and bequeath to her that fractional share of my residuary estate computed as follows:

(1) The numerator shall be the amount by which one half of my adjusted gross estate shall exceed the value of all property which passes or shall have passed to my wife under the provisions of this

If the formula is to be a fractional share, it seems prudent to express it in those terms and not in terms of a "portion," a "percentage," or other potentially ambiguous terms which could (however illogically) be construed as giving the widow an amount equal to the formula-derived sum.

⁷¹ Another author notes that a percentage of the residuary estate is generally accepted as expressing a fractional share. Tarbox, *supra* note 29, at 459.

⁷² Polasky, *supra* note 62, at 840-44.

⁷³ For a discussion of the operation of the pretax residue pattern, see Casner, *How to Use Fractional Share Marital Deduction Gifts*, 99 TRUSTS AND ESTATES 190, 191 (1960).

will, but only to the extent that such property shall be includible in determining my gross estate under the provisions of any law imposing a succession, inheritance, death or estate tax and allowed as a marital deduction.

(2) The denominator shall be the amount of my residuary estate.

The values to be used for the purpose of computing such fractional share shall be the values finally determined in the federal estate tax proceeding and shall be conclusive.⁷⁴

However the fraction is stated, it serves two distinguishable functions: first, it defines the proportionate amount of the residuary estate needed to qualify for the maximum marital deduction; and second, it is used to allocate the residuary estate among the respective beneficiaries at the distribution date.⁷⁵

The following hypotheticals demonstrate the practical application of fractional formula clauses. Assume decedent's adjusted gross estate is valued at \$500,000 on September 1, 1975 and that the amount includes \$100,000 of life insurance that is payable outright to the surviving spouse. If the decedent's will, which contains no specific bequests, divides the estate equally between the surviving spouse and an only child, the surviving spouse would by the terms of the insurance contract be entitled to the \$100,000 of life insurance,⁷⁶ and to \$150,000 by the first illustrated formula clause. The \$150,000 received from the residuary assets is the sum needed to obtain the maximum marital deduction. The surviving spouse receives assets valued at \$250,000, which is one-half of the adjusted gross estate, and the child receives the rest of the estate after the payment of taxes.

If the marital share were expressed in terms of the second formula clause, the same result would be obtained. The numerator of the fraction is \$150,000, which is half the adjusted gross estate less

⁷⁴ It is assumed in both of the above forms that a separate provision will be made for exoneration of the marital deduction share from the payment of taxes and for the exclusion of ineligible property.

⁷⁵ Polasky, *supra* note 62, at 841. As discussed later, the fraction also serves an important role when interim distributions are made. See text accompanying notes 98-99 *infra*.

⁷⁶ Life insurance, although a nonprobate asset, is includible in decedent's gross estate for federal estate tax purposes under CODE, § 2042. For Ohio's estate tax purposes life insurance is excluded from the value of the gross estate:

The value of the gross estate shall not include any amount receivable as insurance under policies on the life of the decedent by beneficiaries other than the decedent's estate, whether paid directly to such beneficiaries or to a testamentary or inter vivos trust for their benefit.

OHIO REV. CODE § 5731.12(A) (1973).

the amount passing to the surviving spouse other than under the marital deduction clause, *e.g.*, the insurance. ($\$500,000/2 - \$100,000 = \$150,000$). The denominator of the fraction is the amount of the residuary estate, \$400,000. When the fraction of $150,000/400,000$ is multiplied by the pretax residuary of \$400,000,⁷⁷ the resulting amount equals the \$150,000 marital share obtained by the first clause.⁷⁸ This amount, when added to the \$100,000 in insurance proceeds received by the spouse, equals \$250,000, the maximum allowable marital deduction. In either case the federal estate tax due on a taxable estate of \$190,000 (\$500,000 less then \$60,000 exemption available under IRC § 2052 and the \$250,000) is \$47,700 and is paid from the child's share of the residuary. The child's share after the payment of taxes is \$202,300.

Unless the will contains a tax apportionment clause or provides some other directions for the payment of estate taxes, the residuary beneficiaries generally bear the burden of these taxes.⁷⁹ Thus, when the formula is applied against the pretax residue, the surviving spouse, as a residuary beneficiary, will be required to contribute to the payment of tax unless the formula or some other provision of the will exonerates the marital share from the payment of taxes. Absent such exoneration, the amount received by the surviving spouse will be reduced by the amount needed to contribute to the payment of estate taxes. Since the federal estate tax depends on the amount of marital deduction and the amount of the marital deduction depends on the amount of the tax to be paid by the surviving spouse, a compounding problem arises. As the surviving spouse's share is reduced to pay the taxes, the total tax due increases, since the amount distributed to the surviving spouse and thus qualifying for the marital deduction is decreased by the spouse's contribution for the payment of taxes. This compounding problem, which can result in the partial or complete loss of the marital deduction, can be avoided by including a tax clause providing that all death taxes shall be paid out of the nonmarital portion of the residuary.⁸⁰ When a post-tax residuary

⁷⁷ The \$100,000 of life insurance is excluded in defining the residue since it passes outside of probate.

⁷⁸ The surviving spouse's share of the residuary would be the same whether the residuary were defined as pretax ($150,000/400,000 \times 400,000$) or post-tax ($150,000/352,300 \times 352,300$) because the denominator of the fraction is equal to the base.

⁷⁹ *Oviatt v. Oviatt*, 24 Ohio Misc. 98, 260 N.E.2d 136 (P. Ct. 1970).

⁸⁰ This result assumes that the size of the nonmarital share is sufficient to pay the taxes. For a discussion of tax compounding problems *see* Treas. Reg. § 20.2056(b)-4(c)(4). The Internal Revenue Service also publishes a pamphlet entitled "Interrelated Death Taxes and the Marital or Charitable Deduction."

bequest is used, the compounding problem is avoided by definition. In that situation the taxes are charged against the whole residuary estate before the surviving spouse's marital share is determined. As long as the pretax residuary bequest includes the direction that the payment of death taxes is to be made out of other assets, the pretax and the post-tax bequests produce equal marital deductions. The distinction between the pretax and the post-tax bequest becomes significant, however, in allocating the increases and decreases in the value of the estate that occur during the period of administration and in allocating income earned by the estate prior to final distribution.⁸¹

When the executor makes a distribution of estate assets to the residuary beneficiaries, the surviving spouse is, as a general rule, entitled to a fractional share of each asset.⁸² When the residuary is divided, however, the beneficiaries may not want to take an equal fractional interest in each asset contained in the estate. They may instead opt for a non-pro rata distribution in which each beneficiary takes the whole of a particular asset so long as the values of the property received are equal as between them. This contingency is often provided for in advance by authorizing the executor to make non-pro rata distributions.

When the residuary bequest is pretax, fractionalization of the residue as initially constituted causes certain tracing problems. Tracing becomes necessary because the surviving spouse has an interest in each asset in the pretax residuary that must be followed through the period of administration, and because of changes in the composition of the residue which occur during the period of administration and affect some, but not all, fractional interests. Changes are precipitated by the payment of estate taxes, from which the surviving spouse can be relieved by a tax clause, and as a result of sales, purchases, and exchanges of estate assets. The administrative problem created by the cumbersome process of tracing is frequently cited as one of the principal disadvantages of the pretax residuary bequest.⁸³ The problem of tracing is, of course, eliminated when the distributable estate consists entirely of cash, but since this type of estate is rare, problems are to be expected.⁸⁴

When the post-tax residuary bequest is used, the ascertained

⁸¹ Kurtz, *Allocation of Increases and Decreases to Fractional Share Marital Deduction Bequest*, 8 REAL PROP., PROBATE & TR. J. 450 (1973).

⁸² Tarbox, *supra* note 29, at 415.

⁸³ Geller, *supra* note 37, at 386.

⁸⁴ Rosen, *supra* note 65, at 59.

fraction is commonly applied to the assets available at the date of distribution rather than to each asset of the residue at the valuation date. The post-tax situation does not require assets to be traced, since any changes in the residuary estate are held for the account of the marital and nonmarital shares in proportion to their fractional interest of each item on the date of distribution. Defining the fund in terms of the post-tax residue not only comports with the use of the term as it is used in probate law,⁸⁵ but also makes the bequest easier to administer, since the need for tracing individual assets through the period of administration can be avoided.⁸⁶

Some authority in Ohio supports the proposition that a fractional share bequest entitles the surviving spouse to a fraction of each asset on distribution.⁸⁷ When the beneficiaries of the decedent's will are entitled to a pro rata division of the estate and they agree to a non-pro rata distribution, the distribution may result in a taxable exchange unless the will or local law provides otherwise.⁸⁸ Estate planners have expressed fears that such non-pro rata distributions can result in a taxable exchange for income tax purposes between beneficiaries, especially if the distribution is based on mutual agreement. The beneficiaries could be deemed to have made a taxable exchange with each other, which would result in the reportable capital gain if the distributed property had increased in value from date of death or alternate valuation date.⁸⁹ Unless one can argue that the beneficiaries have no right to a pro rata distribution,⁹⁰ in which event the Internal

⁸⁵ Kurtz, *supra* note 81, at 451.

⁸⁶ If the fraction is to be applied to each asset of the residue as initially constituted, rather than to those assets comprising the residue at the date of distribution, then tracing would be appropriate. As Polasky observes, "mercifully, perhaps, most commentators have not mentioned the issue [tracing in the post-tax situation] when discussing fractional share clauses." Polasky, *supra* note 62, at 845.

⁸⁷ 7 R. HAUSER & A. DIENFENBACH, OHIO PRACTICE § 2120 (B) (1969) states: "In a simple fractional share bequest the surviving spouse will be entitled to a fraction of each asset," and the OHIO LEGAL CENTER INSTITUTE, REFERENCE MANUAL FOR CONTINUING LEGAL EDUCATION, PROBATE VI, Vol. 71, ¶ 8.14 (1971) notes: "The fraction determined under the formula is to be applied to each asset." Notwithstanding this, Platt argues that the fractional share clause does not give the surviving spouse the right to demand a fractional interest in each asset in the residuary estate unless this form of distribution is required by the will. Platt's technical argument is based on the payment of legacies statute and the powers it vests in the executor. Platt, *supra* note 68 at 4.2-5(b).

⁸⁸ Rev. Rul. 69-486, 1969-2 CUM. BULL. 159. The Ruling implies that if the fiduciary were authorized either by local law or the dispositive instrument to make a non-pro rata distribution in kind, the treatment of the exchange as taxable might be different.

⁸⁹ Moore, *Estate Planning Opportunities Which May Be Possible Under the Uniform Probate Code*, 1 ESTATE PLANNING 89 (1974).

⁹⁰ *Supra*, note 83. Covey argues that there is no duty to fractionalize under state law, but

Revenue Service is likely to be unsuccessful in claiming that the beneficiaries were exchanging property with one another, the prudent alternative is to expressly authorize the executor to make non-pro rata distributions. Inclusion of such a provision should prevent the distribution being treated as a taxable exchange.

D. *Administration of the Fractional Share Bequest*

The special needs of beneficiaries during the time needed to settle an estate frequently necessitate interim distributions of either estate income or principal.⁹¹ If the executor either does not make interim distributions or makes only pro rata distributions to the residuary beneficiaries, no particularly difficult problems arise in allocating income or the changes in the value of the estate between the marital and nonmarital share as determined by the formula fractional bequest, since the relative interests of the beneficiaries remain constant.

When the surviving spouse's interest in the residuary remains the same during the period of administration, the easiest method of allocating changes is by the application of a constant percentage or fraction.⁹² Under this approach the numerator of the allocation fraction is equal to the value of the surviving spouse's share of the residuary and the denominator is equal to the value of the residuary, which can be either pretax or post-tax, depending on the will. When the post-tax residuary is used as the denominator of the allocation fraction, the surviving spouse's share of changes will be greater than when the pretax residuary is used. This result is to be expected, since the surviving spouse's percentage interest in the residuary is greater in the post-tax situation than in the pretax situation.

In casting the fraction, the election to take certain expenses as income tax deductions⁹³ does not alter the fact that these expenses are normally principal charges against the residuary during the entire

only the duty to be fair. Covey, *The Marital Deduction*, PRACTICING LAW INSTITUTE, ESTATE & GIFT TAXATION 213, 218 (1971). Many commentators conclude that fractionalization is required. See, e.g., Edwards, *Marital Deduction Formulae—A Planner's Guide*, 1967 DUKE L.J. 254, 264.

⁹¹ Dole, *A Technique for Making Distribution From Principal and Income to Residuary Beneficiaries During Administration of Estates—With Application to Trusts*, 79 HARV. L. REV. 765, 766 (1966).

⁹² Kurtz, *supra* note 81, at 457.

⁹³ *Id.*, at 454.

period of administration.⁹⁴ Failure to deduct the charges in determining the size of the denominator will result in the surviving spouse receiving a proportion of the change that is less than the spouse's respective interest in the residuary.⁹⁵ Therefore, regardless of how the executor exercises any election, the denominator of the allocation fraction should be reduced to reflect all charges against the residuary during the entire period of administration. The fraction is applied to income accumulated during administration and to those assets that comprise the residue at the distribution date for the purpose of determining the surviving spouse's share of the change.⁹⁶

However, when non-pro rata partial distributions of either principal or income to individual beneficiaries are necessary, the process of allocation becomes more complex and can be fairly described as being one of the most difficult tasks the executor is required to perform. Such non-pro rata partial distributions change the beneficiaries' relative interest in the remaining undistributed residue. As a result, the application of the constant percentage approach, which worked well when no interim distributions or pro rata distributions were made, can produce inequitable results.⁹⁷ A simple example will illustrate this. Assume that at the valuation date the residuary estate is composed of one hundred shares of stock and that the executor makes a non-pro rata partial distribution to the surviving spouse of forty shares of the stock before final distribution. Assume also that after the partial distribution the value of the stock increases substantially. If the surviving spouse is permitted to share in the appreciation of the stock held by the estate, in accordance with the fraction as cast in terms of the initial marital share of the residue, then the surviving spouse would receive a greater proportional share of the change than would be the case if no partial distribution were made.

⁹⁴ Covey, *supra* note 90, at 255.

⁹⁵ In determining the size of the marital deduction, failure to deduct principal charges when the bequest is defined in terms of the fractional bequest will result in the underqualification of the marital deduction. The same basic effect occurs when the executor is allocating the changes which occur during administration.

⁹⁶ See *In re Shubert's Will*, 10 N.Y.2d 461, 180 N.E.2d 410, 225 N.Y.S.2d 13 (1962). This decision was legislatively reversed by N.Y. EST., POWERS & TRUSTS § 11-2.1(d) (McKinney 1967).

⁹⁷ The estate accounting burdens may well account for the reluctance of corporate fiduciaries to make non-pro rata partial distributions during administration. Polasky, *supra* note 62, at 852.

This inequity can be avoided if the allocation fraction is recomputed after each partial distribution. The fraction should be recomputed so that future distributions to beneficiaries are in proportion to their respective interests in the undistributed assets of the estate, on the basis of the fair market value of those assets after making the partial distribution. This recomputation requires that the estate be revalued after each partial distribution and that the fraction be recast in terms of current fair market values.

Recomputation is also necessary when the pretax residuary clause is used, since the surviving spouse's share in the undistributed residue also changes after the payment of estate taxes. When the estate taxes are charged to the nonmarital share the effect is the same as if a partial distribution had been made solely to the nonmarital share.⁹⁸

In order to accurately determine the surviving spouse's proportionate interest in the undistributed assets, the executor during the revaluation process should insure that the numerator of the fraction is reduced by distributions to the surviving spouse and the denominator is reduced by distributions to the surviving spouse, other beneficiaries, and the payment of other charges against the residuary estate. The recast fraction is then used for purposes of allocation until the next partial distribution is made, at which time the process of recomputation is repeated.⁹⁹ This recomputation must be made every time an unequal interim distribution is made and, in the pretax residuary situation, when the estate taxes are paid.

In casting the original fraction, the denominator, which is defined as the value of the residuary estate as finally determined for federal estate tax purposes, should be reduced by any principal charges including accounting charges against the residuary estate to avoid overstating the residue. This reduction in the denominator is the same type as is made when the constant percentage is used.

IV. CONCLUSION

Drafting a will that gains maximum tax advantages and also satisfies the testator's planning objectives is not an easy task, but it is one estate planners must routinely perform. Successfully meeting this challenge requires a broad understanding of testators' prob-

⁹⁸ Kurtz, *supra* note 81, at 452.

⁹⁹ The complexity of this administrative revaluation is one of the reasons estate planners have turned away from the formula fractional bequest.

lems and the techniques available to meet them, in addition to a painstaking attention to detail. This article has analyzed one of the most important of these tax planning devices, the marital deduction formula clause.

Formula marital deduction clauses are intended to ensure that the value of the assets passing to the surviving spouse will be exactly equal to the maximum marital deduction allowed for federal estate tax purposes. As would be anticipated, their effective use depends on the circumstances of each individual estate. The interaction of state law with the formula chosen, whether pecuniary or fractional, can present knotty problems of planning and administration for the estate planner, but those problems can and must be mastered if the needs of the testator are to be met.